

Classification Pre-Assessment Survey

Internal Control Technical Guide

Objective

Provide guidance for performing a Pre-Assessment Survey (PAS) of the company's internal control for classification and evaluating the results.

Background

Generally Accepted Government Auditing Standards require the PAS team to obtain a sufficient understanding of internal control to plan the audit and determine the nature, timing, and extent of tests to be performed.

The guidelines and terms in this technical guide are based on *Assessing Internal Controls in Performance Audits*, GAO/OP-4.1.4, published by the United States General Accounting Office, Office of Policy, September 1990, and the American Institute of Certified Public Accountants Statement on Auditing Standards No. 78.

19 CFR 141.86(a)(3) states that each invoice of imported merchandise shall set forth a detailed description of the merchandise, including the name by which each item is known, the grade or quality, and the marks, numbers, and symbols under which it is sold by the seller or manufacturer to the trade in the country of exportation, together with the marks and numbers of the packages in which the merchandise is packed.

19 CFR 141.87 states that whenever the classification or appraisement of merchandise depends on the component materials, the invoice shall set forth a breakdown giving the value, weight, or other necessary measurement of each component material in sufficient detail to determine the correct duties.

19 CFR 141.89 states that additional invoice information is required for certain classes of merchandise in order to determine admissibility and merchandise classification.

19 CFR 152.11 requires merchandise to be classified in accordance with the Harmonized Tariff Schedule of the United States (HTSUS) (19 U.S.C. 1202) as interpreted by administrative and judicial rulings.

Examples of Red Flags

The following examples are conditions that may indicate a potential problem in classification:

- The company has insufficiently documented, poorly defined, or no internal control for accurately reporting classifications to Customs.
 - ✓ The company does not monitor or interact with the broker on classification issues.
 - ✓ The company relies on one employee to handle classification issues, and there are poor or no management checks or balances over this employee.
- Company import staff lacks knowledge of classification requirements.
- The company offers unreasonable explanations to Customs.
- The company fails to cooperate with or respond to Customs.
- The company has a high turnover of people in key positions.
- Significant variances exist between the importer's data and Customs data.

- Customs (e.g., import specialist, account manager, compliance measurements, prior audit) shows a history of problems with classification.
- The company uses HTSUSs with known or suspected problems as identified by Customs.
- HTSUSs are complex, or merchandise is classified under a broad range of HTSUSs that would require extensive knowledge to classify.
- The company imports a wide variety of merchandise but enters the merchandise under only a few classifications.
- The company's import pattern has changed.
- Competing HTSUSs have a lower duty rate or relaxed admissibility requirements.
- The company has been referred to enforced compliance (Enforcement Evaluation Team).

Examples of Best Practices

- Internal controls over classification:
 - ✓ Are in writing;
 - ✓ Include procedures for monitoring and feedback; and
 - ✓ Are monitored by management.
- One manager is ultimately responsible for control of the Import Department, including proper classification of merchandise. That manager has knowledge of Customs matters and the power to ensure that internal control procedures for imports are established and followed by all company departments.
- Written internal control procedures assign classification duties and tasks to a position rather than a person.
- The company has good interdepartmental communication about Customs matters.
- The company requests binding rulings and consults with Customs import specialists.
- The company conducts and documents periodic reviews of merchandise classification and uses the results to make corrections to entries and changes to its import operations as appropriate.
- The company requires that vendors provide sufficient descriptions of merchandise on invoices to permit proper classification.
- The company requires periodic training for staff responsible for classifying merchandise.
- The company attends Customs informed compliance outreach and seminars or attends Customs-related seminars provided by private vendors regarding classification issues.
- The company maintains a database of classifications for its product line and requires the classification to be shown on invoices.
- The company requires engineers to obtain the classification for a new part from the Import Department before obtaining a purchase order to buy the part.

Examples of Documents and Information to Review

- Internal control policies and procedures
- The company's responses to the questionnaire
- Interviews with company staff concerning actual procedures and internal control specific to classification
- Documentation that supports monitoring and verification of established and/or written internal control for classification

- Other documents supporting proper classification, such as invoices, engineering drawings, and other descriptive information
- Headquarters and New York rulings issued to the company and/or rulings issued for identical/similar products imported by the company
- Import specialist team files, including CF 28s and CF 29s issued to the company

Suggested Testing

PAS team judgement should be used to determine the type and amount of testing needed to evaluate how effective internal control is and to determine whether there is a sufficient risk to warrant proceeding to Assessment Compliance Testing (ACT).

Using the chart and the guidelines below, determine through limited judgmental testing whether the company's internal control is effective.

To determine the extensiveness of internal control testing, it is necessary to evaluate:

1. The **risk exposure**; and
2. The **internal control** system, by determining whether the controls are in operation, how the controls are applied, how consistently they are applied, and who applies them.

Risk Exposure

Risk exposure is the probability of significant Customs noncompliance. In each step of determining risk exposure, consideration should be given to:

1. Significance (to Customs) and sensitivity (e.g., issues of interest to Congress or the media, or impacting admissibility)
2. Susceptibility (of making incorrect declarations)
3. The existence of any "red flags"
4. Management support (of strong internal control)
5. Competent personnel (to adequately administer the controls)

Steps to Determine Risk Exposure

1. Evaluate problems identified in the profile, compliance measurement rates, questionnaire, and concerns raised by the import specialist and account manager.
2. Perform the macro risk analysis tests.
3. Analyze all results to determine the risk exposure level.
4. Evaluation of risk exposure is not simply a one-time process that occurs at the start of the PAS process. Continually reassess risk exposure as more information is gathered from evaluating internal control and performing other work in the PAS.

Macro Risk Analysis Examples

Example A: Low Risk Exposure

The import specialist identifies four possible HTSUSs that should be used for the products imported by the company. The computer audit specialist (CAS) verifies that the company has used only four HTSUSs during the past fiscal year. The duty rates for each of the four HTSUSs are the same. Compliance measurement rates are acceptable. The import specialist and account manager do not have any concerns. Therefore, the macro risk analysis indicates a low risk exposure.

Example B: High Risk Exposure

The importer imports \$450 million in fasteners annually. The import specialist advises that misclassifications are a frequent problem in the fastener industry and that the company has not contacted him for classification guidance. In addition, the company uses numerous classifications for its imports. Because problems frequently occur in this industry, the import specialist has had no interaction with the company regarding classification, and the company uses numerous classifications, the macro risk analysis indicates a high risk exposure.

System of Internal Control

To evaluate the internal control system:

1. Consider the five components of internal control:
 - Control Environment
 - Risk Assessment
 - Control Activities
 - Information and Communication
 - Monitoring
2. Review relevant Customs and company documents to identify and understand relevant internal control over classification. (Examples of documents and information to review are listed above.)
3. Determine whether the company has established and follows procedures. Review:
 - Documentary evidence of the results of periodic internal control reviews/testing and corrective action implemented
 - Documentary evidence of communication between the broker and company on classification issues, company testing of broker operations, and verification that the broker followed company instructions
 - Company-specific rulings and evidence that they are followed
 - Documentary evidence of intercompany communications to ensure that correct information is provided to Customs
 - Training records and materials used to educate staff on classification issues
4. Review written policies and procedures and interview applicable company personnel to complete appropriate sections of the "Worksheet for Evaluating Internal Control Over

Classification". If applicable, include quota, antidumping duties, admissibility requirements, and other classification issues.

Note: The internal control assessment should include steps to:

- Identify and understand internal control
- Determine what is already known about control effectiveness
- Assess the adequacy of internal control design
- Determine whether controls are implemented and effective
- Determine whether transaction processes are documented

Extensiveness of Audit Tests (Testing Limit)

The purpose of limited PAS testing is to take a survey in order to determine the necessity for and extent of substantive tests. In some circumstances, the PAS team may decide that it probably will not be able to form an opinion based on limited PAS testing. In such cases, it may be necessary to proceed immediately to the ACT process. If the PAS team believes that it can form an opinion based on limited PAS testing, it should test the appropriate number of controls and associated transactions using the table below. Tests may be appropriate for various areas below the classification level that compliance will be reported on. For example, the company may import under numerous classifications, but the PAS team may decide that testing may be necessary only for certain classifications or types of imports that have been identified as the primary risks.

Determine Extensiveness of Audit Tests

Risk Exposure	+	Preliminary Review Internal Control	=	Extensiveness of Audit Test	Testing Limit
High		Weak Adequate Strong		High Moderate to High Low to Moderate	10-20
Moderate		Weak Adequate Strong		Moderate to High Moderate Low	5-15
Low		Weak Adequate Strong		Low to Moderate Low Very Low	1-10

Source: Adapted from *Assessing Internal Controls in Performance Audits*.
Column titled "Testing Limit" reflects Customs test sizes.

Example (Determination of Testing Level)

Based on a review of the profile (Compliance Measurement (CM) rates were high), questionnaire, written procedures, etc., the team concludes that the preliminary risk exposure is moderate.

The company's internal control procedures manual requires the import manager to review every 50th transaction to ensure that the merchandise is correctly classified and to maintain a

"Classification Review Log" to document this process. The import manager documents the transactions she reviews, identifies misclassifications, and files corrected entries. The log shows that misclassified items have been corrected in the company's classification database and with Customs. The team concludes that the internal control system over classification is strong.

Using the table above (based on a moderate risk exposure and strong preliminary internal control evaluation), the team concludes that it will test five control items. The team judgmentally selects three items from the "Classification Review Log". The team import specialist verifies that two classifications were accurate and one incorrect classification had been corrected. The import specialist reviews two additional entries and determines that the classifications were correct. The company's import manager provides evidence that all entries of the incorrectly classified parts had been corrected. The team verifies that the company took action to prevent future misclassification by examining changes to the classification database and by confirming that classifications on subsequent entries were correct.

Evaluation of Pre-Assessment Survey Testing Results

The following steps are guidance for determining the effectiveness of company's internal control over classification.

1. Complete the "Worksheet for Evaluating Internal Control Over Classification" to determine whether risk determination is acceptable or unacceptable and document why. Put the results of testing in perspective and evaluate confirmed weakness as a whole. The evaluation should consider the results of the internal control testing, problems identified in the profile, and/or concerns raised by the import specialist and account manager. The team must evaluate the PAS results based on the specific situation(s).

Customs considers risk to be unacceptable when testing reveals that internal control is not effective, or not sufficient, to provide reasonable assurance that accurate, timely, and complete declarations are reported to Customs.

2. Obtain the PAS import specialist's opinion of the adequacy of controls and the significance of weaknesses identified. Existing guidelines should be used when contacting national import specialists if their assistance is needed.
3. The following will help the PAS team determine whether conditions warrant proceeding to ACT:

- **Do not proceed to ACT (Revenue) if:**

- ✓ Cost-benefit analysis warrants no further effort (do not spend a significant amount of resources to identify a potential loss of revenue considered insignificant).
- ✓ The PAS indicated that the classification error was due to an isolated incident.
- ✓ The company agrees with the PAS finding(s) and agrees to quantify the loss of revenue within an acceptable time frame.

- **Do not proceed to ACT (Compliance) if:**

- ✓ An incorrect classification was an isolated error, and the importer can show identical entry lines with the correct classification.
- ✓ The incorrect classifications were systemic, and the importer agrees to develop and implement a compliance improvement plan within an acceptable time frame.

- **Proceed to ACT (Revenue) if:**
 - ✓ The company does not have adequate internal control, and the PAS indicated material loss of revenue that cannot be quantified without statistical sampling or further review.
 - ✓ The Importer will not quantify loss of revenue.
- **Proceed to ACT (Compliance) if:**
 - ✓ The company refuses to take corrective action on systemic errors, and it is necessary to calculate a compliance rate.

Note: If substantive tests necessary to determine a compliance rate or revenue loss can be performed quickly and without extensive effort, the team should immediately perform the substantive tests without proceeding to ACT.

4. Determine whether referrals should be made for enforcement action.

Examples

The following examples of situations that might be encountered under the PAS *are for clarification only*:

Example A: Situation in which the team would not proceed to ACT (Revenue)

The company's written procedures require the Customs Department to provide the broker with specific information (specification sheets, rulings, and complete descriptions) for use in classifying merchandise. The company is required to randomly test X percent of broker-filed entries each month to determine whether classifications were correct and to notify the broker by email if corrections are needed. The broker is required to send the company copies of corrected CF 7501s.

The team:

- Determines that 20 items should be tested, based on:
 - ✓ The high preliminary risk exposure level (Congressional interest in import commodity and import specialist concerns).
 - ✓ The adequate preliminary internal control evaluation (there was no procedure to monitor broker corrections).
- Does not complete a macro test because the data was not readily available.
- Reviews the company's "Classification Audit Log" to verify that the company had tested X percent of the entries during the past few months.
- Identifies five misclassifications that the company had asked the broker to correct and verifies that the broker had corrected the classification but had not notified the company of the correction.
- Selects several entry summaries, judgmentally selects 15 line items, and confirms that classifications were correct.

The company agrees that the import manager will monitor the broker's corrections in the future. The team concludes that proceeding to ACT will not be necessary because:

- The PAS team has verified classifications were corrected and did not result in unpaid duty.
- The company has elevated its monitoring of the broker to a management level.

Example B: Situation in which the team would not proceed to ACT (Compliance)

The team does not identify any concerns in the questionnaire, profile, or interviews. The company has implemented its written internal control procedures, which:

- Assign the company's in-house broker the responsibility for classifying imported merchandise
- Require the import manager to review/test classifications used during the month
- Require the import manager to periodically communicate with and train other departments, such as Engineering and Purchasing, on classification requirements

The team concludes that the preliminary risk exposure is low and internal control is strong. The team judgmentally tests four classifications and finds the merchandise is properly classified. Since internal control was implemented and effective and no incorrect classifications are found, the team concludes that there are no unacceptable risk areas and does not proceed to ACT compliance testing.

Example C: Situation in which the team would proceed to ACT for (Revenue)

The team finds the same situations as identified in example B. However, the import specialist determines that the classifications tested were not correct and there was a significant loss of revenue on a number of items. The team proceeds to ACT to determine loss of revenue.

Example D: Situation in which the team would proceed to ACT (Compliance)

In the same situation as example A above, the company stopped reviewing the broker's classifications 2 years before, when a new import manager was hired. PAS testing of 20 classifications shows that three were incorrect. The PAS team considers the breakdown in the company's control system significant enough to proceed to the ACT process to quantify the level of noncompliance.

Worksheet for Evaluating Internal Control Over Classification

Objective: Determine whether the company has procedures designed to effectively control Customs risks related to classification.

Risk Determination:

Acceptable

Unacceptable

Internal Control	Yes	No	Not Applicable	Internal Control Manual Page Number	Work Paper Reference	Comments
Are internal controls over classification formally documented?						
Are written policies and procedures approved by management?						
Are written policies and procedures reviewed and updated periodically?						
Do written internal control procedures assign classification of merchandise to a position rather than an individual?						
Does the company have good interdepartmental communication about classification matters?						
Is one department/individual primarily responsible for classifying imported merchandise?						

Internal Control	Yes	No	Not Applicable	Internal Control Manual Page Number	Work Paper Reference	Comments
Does the individual classifying merchandise have adequate knowledge and training and authority to ensure that internal control procedures for imports are established and followed by all company departments?						
Are internal controls over classification periodically tested?						
Were the results of the periodic internal control tests documented?						
If weaknesses were found during internal control testing, were corrective actions implemented?						
Does the company use results of testing to make corrections to entries when appropriate?						
Are Harmonized Tariff Schedule classifications maintained in a database that is provided to brokers?						
Is Customs assistance sought in classifying merchandise (e.g., requesting binding rulings)?						
Are suppliers required to print company-provided HTSUSs on invoices and/or packing lists?						

Internal Control	Yes	No	Not Applicable	Internal Control Manual Page Number	Work Paper Reference	Comments
Is adequate descriptive information provided to the Import Department and/or broker by suppliers, engineers, the Purchasing Department, etc., to ensure proper classification?						
Does management review the classification of new items on a periodic basis?						
Does the company review or monitor entries to verify that correct classifications were used?						
Are brokers required to have written company approval to make classification changes?						
Internal Control Conclusions						
Is broker oversight adequate?						
Did PAS testing verify that control procedures were being followed?						
Did interviews with responsible persons support control procedures?						
Does the company have adequate internal control to address specific issues identified in the profile?						
List company-specific procedures below (if applicable)						